Economic Outlook

The national and California economies continued to recover.

After ending 2010 with some momentum, positive economic signs continued during the early months of 2011. Labor market conditions improved, based on accelerating job growth, declining jobless claims, and a declining—although still high—unemployment rate. Industrial output rose, including growth in manufacturing. Exports posted a solid year-over-year gain during the first quarter of the year.

However, weak housing markets, depressed construction activity, and public sector fiscal problems continued to dampen economic growth. Two major international developments—unrest in oil-producing nations and the Tohoku Pacific earthquake and tsunami that struck Japan—resulted in more uncertainty for the outlook. On balance, the short-term forecast improved somewhat but gained some new downside risks. The strength of the recovery and out-year forecast remains uncertain.

The Nation

Economic forecasts improved following the announcement of new economic stimulus measures at the end of 2010. The Governor's Budget forecast reflected the Federal Reserve's purchase of $600 billion in long-term Treasury bonds and assumed that Congress would extend both the existing federal income tax cuts and long-term unemployment benefits. An additional stimulus policy came in the form of a temporary payroll tax cut that should stimulate consumer demand.

However, this new optimism was counter-balanced by new global turbulence. The spreading unrest in and around major oil-producing countries quickly drove up oil prices in the early months of 2011. The price of West Texas Intermediate (WTI) crude oil went from $89 per barrel at the beginning of the year to $109 in the first week of April. Based on past experience, a $20 rise in the price of a barrel of oil could raise gasoline pump prices by about 48 cents, which would raise the Consumer Price Index 0.8 percent. Higher pump prices will raise spending on gasoline by about $60 billion—with a corresponding reduction of spending on other things—and reduce GDP by 0.2 percent.

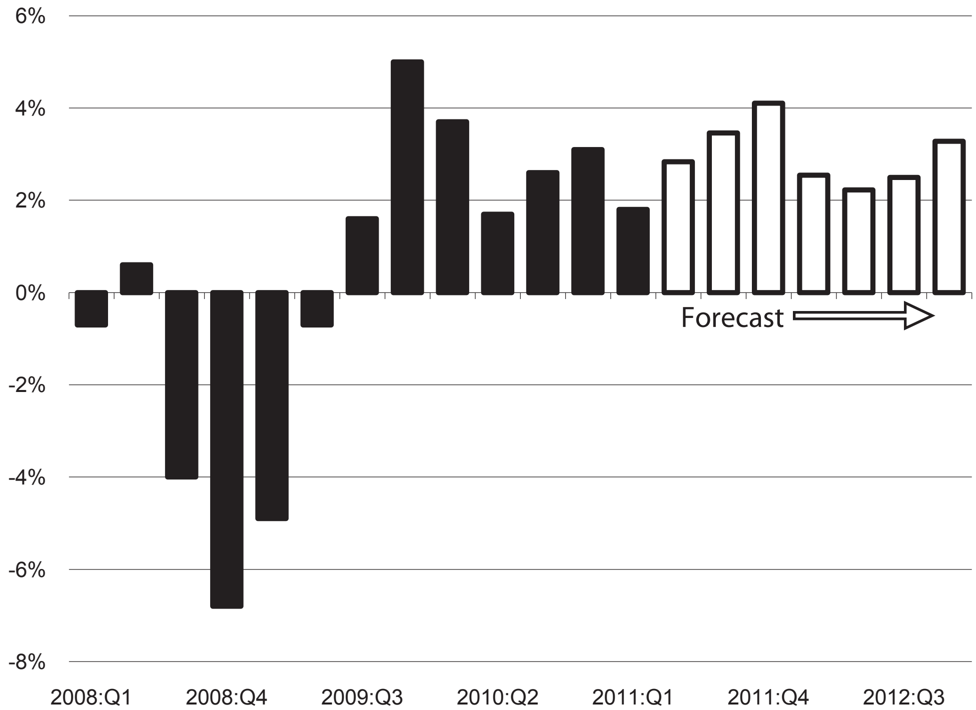
The Tohoku Pacific earthquake and tsunami which struck Japan on March 11 was the most serious natural disaster to hit Japan since the Kobe earthquake of 1995. Early damage cost estimates ran up to $200 billion, or around 4 percent of Japanese GDP. Given Japan's importance to the global economy, there is concern about the economic ripple effects that could result. The biggest threat would be extended problems with Japan's energy grid. Barring this, expectations are that Japanese companies will quickly work around the current difficulties. The Japanese economy is also large enough—about $5 trillion a year—to absorb the rebuilding costs.

Overall, the U.S. national recovery should withstand these shocks. 2010 ended stronger than anticipated in the Governor's Budget forecast. Real GDP growth in the third quarter was revised upward, from 2.0 percent to 2.6 percent. Growth in the fourth quarter was stronger than first predicted, 3.1 percent versus 2.2 percent (Figure ECO-01).

The national economy started off 2011 with momentum. Job creation accelerated during the first quarter. Nearly 160,000 new jobs were created each month on average during the first three months of 2011. During 2010, the average monthly gain was only 78,000 jobs. The unemployment rate dropped a full percentage point from November 2010 to March 2011, from 9.8 percent to 8.8 percent. While this rate is still painfully high and there is still a long way to go to recoup the eight million jobs lost during the recession, labor markets appeared to be making steady progress.

Industrial output made a strong recovery. In March, manufacturing activity not only expanded for the twentieth consecutive month, but grew at its second best pace in nearly 30 years. Manufacturing output received a large boost from strong growth in motor vehicle production. Better factory activity also generated gains in manufacturing jobs that appeared to end a long decline that stretched back to 1998. By March, the industrial sector had recovered nearly 60 percent of its recessionary decline.

Figure ECO-01
National Real GDP
Quarter-to-Quarter Growth, Annualized



Source: U.S. Bureau of Economic Analysis; CA Department of Finance May Revision Forecast

After incorporating these developments, the national outlook projects the recovery continuing, albeit at a meager pace by historical standards. GDP growth will continue, but will slow slightly in 2011 — 2.8 percent year-over-year versus 2.9 percent in 2010. The unemployment rate will trend down throughout 2011, but will still average almost 9 percent for the year.

California

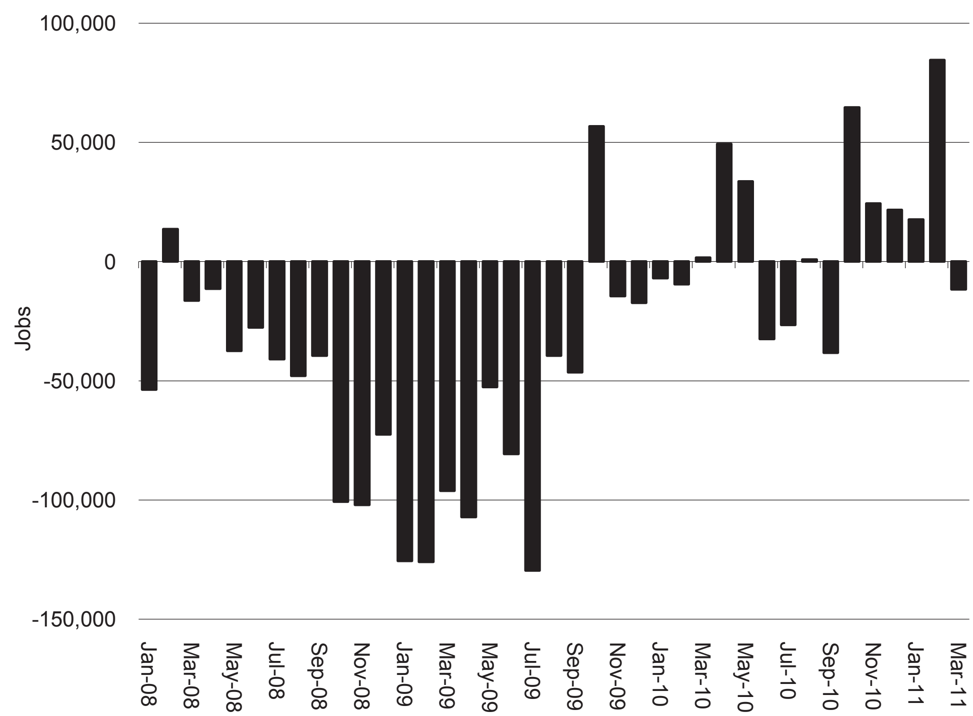
California was also buffeted by the same developments that affected the national outlook. A modest recovery is still underway but more uncertainty looms. Weak real estate market conditions, depressed construction activity, and public sector fiscal problems remain the principal impediments to stronger job growth.

The earthquake in Japan is of special concern to California because of the significant economic links to Japan, which include integrated two-way trade in high-technology goods, extensive vehicle imports, lucrative agricultural exports, and tourism. Japan is the fourth-largest foreign market for California's goods exports, after neighboring Mexico, Canada, and the trade giant China. California is also a very popular vacation destination for Japanese tourists, just as Japan is for Californians. According to preliminary data for 2010, California received 557,000 visitors from Japan who spent approximately $1,100 per trip, which translated into approximately $600 million of economic activity. Japan is a major supplier of electronic components to the Silicon Valley. Despite the devastation, high-tech industry experts don't anticipate long-term effects on the supply chain that connects Japan with the Silicon Valley.

As with the nation, 2010 was a transition year during which the severe job losses from the recession switched to modest gains. This trend continued into the early months of 2011 as shown in Figure ECO-02. California gained nonfarm jobs in five out of the six months ending with March, averaging over 30,000 new jobs each month. This was a considerable improvement from the 7,000 average monthly gains during 2010 as a whole and the monthly average loss of 65,000 jobs during 2009.

Figure ECO-02

California Nonfarm Payroll Employment
Month-over-Month Change



Source: Employment Development Department, Labor Market Information Division

California added 90,600 jobs during the first three months of 2011. On a year-over-year basis, employment in the state grew faster than in the nation as a whole — 1.2 percent versus 0.9 percent. The strongest growth was in the Professional and Business Services sector, which includes the high-paying professional, scientific, and technical services and employment services (temporary help) subsectors. The state's unemployment rate was still painfully high early in 2011, but had improved — down to 12.0 percent in March from 12.5 percent in December 2010. Even so, the state's job total remains about 1.2 million below its peak total in July 2007. The state is forecast to recover the nonfarm jobs lost during the recession in the third quarter of 2016, or approximately 86 months after the end of the recession.

The public sector and the housing and finance industries continue to lag the recovery. There is still no sign of a strong rebound for the state's housing market and there remains considerable uncertainty looking forward. Job growth, while improving, is still weak, particularly for new entrants to the labor market. The building industry itself was so severely stricken by the recession that new home delivery would be slow to come even if demand dramatically improved.

Budget problems continue to depress public sector employment. Even though private sector employment in California began growing after the first quarter of 2010, state and local government employment was still falling during the early months of 2011. Whereas private employment during the first quarter of 2011 was up 1.8 percent from the first quarter of 2010, state and local government employment was down 3.1 percent over the same period.

The Forecast

Both the nation and California appear to be in the midst of a modest, drawn-out recovery. The private sector — outside of homebuilding — is leading the way. For California, export-driven and high-technology sectors are doing particularly well due to the general recovery of the global economy.

Despite recent upbeat indications, the return to pre-recession conditions will be slow and steady. Financial crises historically lead to prolonged readjustment periods that last for years. The steep drop in home values means that a full recovery in residential construction and all associated sectors could be delayed for several years. Likewise, government spending and public sector employment will be lower for the foreseeable future. According to this outlook, industry employment in California is not expected to return to its prerecession level until 2016 and the state's unemployment rate may not achieve full employment for several years thereafter.

Compared to the nation, California suffered a larger drop in personal income from the peak year 2007 to the bottom of the recession in 2009. Growth rates coming out of the recession will be initially weaker for California as well — 2.1 percent in 2010 and 4.4 percent in 2011 versus 3.1 percent and 5.2 percent for the nation—but then the forecast projects that California's growth will exceed the national totals in 2012 and 2013 — 4.5 percent and 5.1 percent respectively compared to 3.7 and 4.6 percent for the nation. This reflects strong growth in several high-wage sectors including information services, computer systems design, and scientific and technical research.

There are risks to the outlook. While the impact of Japan's nuclear and energy crises are limited at present, their ultimate impact is still uncertain. World oil prices will likely be elevated for the foreseeable future. Inflationary concerns recently prompted China's government to take steps to slow the growth of its economy. If successful, this could significantly dampen growth in a number of countries including the U.S. Lastly, ongoing financial problems in several European nations still present risks. See Figure ECO-03 and Figure ECO-04 for highlights of the national and California forecasts.

Figure ECO-03

Selected U.S. Economic Indicators

	2010 (Est.)	**2011 (Projected)**	**2012 (Projected)**
Real gross domestic product, (2005 dollar) (Percent change)	2.9	2.8	2.9
Personal consumption expenditures	1.7	2.6	2.6
Gross private domestic investment	17.1	7.3	10.3
Government purchases of goods and services	1.0	-1.1	-1.9
GDP deflator (2005=100) (Percent change)	1.0	1.5	1.7
GDP (Current dollar) (Percent change)	3.8	4.4	4.6
Federal funds rate (Percent)	0.18	0.17	1.28
Personal income (Percent change)	3.1	5.2	3.7
Corporate profits before taxes (Percent change)	36.8	-6.4	1.3
Nonfarm wage and salary employment (Millions)	129.8	131.4	133.8
(Percent change)	-0.7	1.2	1.8
Unemployment rate (Percent)	9.6	8.8	8.2
Housing starts (Millions)	0.59	0.62	1.04
(Percent change)	5.6	5.2	68.2
New car and light truck sales (Millions)	11.5	12.9	14.7
(Percent change)	11.0	11.7	13.9
Consumer price index (1982-84=100)	218.1	223.2	227.4
(Percent change)	1.6	2.4	1.9

Forecast based on data available as of April 2011.
Percent changes calculated from unrounded data.

Figure ECO-04

Selected California Economic Indicators

	2010	Percent change	Projected 2011	Percent change	2012	Percent change
Personal income ($ billions)	1,606.1	2.1%	1,677.0	4.4%	1,751.8	4.5%
Nonfarm W&S employment (thousands)	13,893.1	-1.4%	14,068.2	1.3%	14,328.6	1.9%
Mining and logging	26.5	1.6%	27.1	2.0%	28.0	3.6%
Construction	559.5	-10.3%	565.6	1.1%	577.1	2.0%
Manufacturing	1,241.6	-3.2%	1,256.8	1.2%	1,281.7	2.0%
High technology	343.3	-1.9%	350.3	2.1%	360.8	3.0%
Trade, transportation, & utilities	2,616.9	-1.0%	2,661.4	1.7%	2,708.5	1.8%
Information	428.1	-2.8%	450.1	5.2%	472.5	5.0%
Financial activities	760.4	-2.9%	761.9	0.2%	778.4	2.2%
Professional and business services	2,067.4	0.4%	2,143.3	3.7%	2,208.0	3.0%
High technology	318.4	2.6%	323.2	1.5%	333.2	3.1%
Educational and health services	1,786.3	1.5%	1,827.8	2.3%	1,866.2	2.1%
Leisure and hospitality	1,497.9	-0.4%	1,522.6	1.6%	1,536.3	0.9%
Other services	482.0	-0.9%	481.3	-0.1%	497.1	3.3%
Government	2,426.6	-2.1%	2,370.4	-2.3%	2,374.9	0.2%
Unemployment rate	12.4%		12.1%		10.8%	
Housing permits (thousands of units)	45	22.9%	55	22.1%	87	58.4%
Consumer price index (1982-84=100)	226.9	1.3%	232.1	2.3%	236.6	1.9%

Forecast based on data available as of April 2011.
Percent changes calculated from unrounded data.